When "Free" is Expensive

The hidden costs of 401(k) plans

Introduction

The fees that 401(k) plan participants pay are often hidden, obscured and buried, a fact which increasingly frustrates financial advisors, plan sponsors and participants—and government regulators. As noted ERISA attorney Marcia Wagner writes, "A sponsor might select what appears to be a 'free' administrative service for the plan, not realizing that plan participants are bearing the true cost of such services in the form of higher expenses in the plan's investment funds."[1]

Inevitably, fees whether hidden or disclosed, often have a particularly significant impact on small to mid-sized plans. As the *Wall Street Journal* noted, "Many large providers of 401(k)s for small businesses don't give their customers a detailed breakdown of the estimated annual costs and where the fees go, making it difficult for employers to comparison shop."[2]

Using iShares® Exchange Traded Funds (ETFs) in a 401(k) plan can eliminate much of the confusion for plan sponsors and participants around what—and how much—they are paying. iShares ETFs have low expense ratios, and no loads, 12(b)-1 fees, or other cross-subsidy arrangements. Recordkeeping fees are separate, and fully disclosed and transparent.

The Department of Labor has released rules to bring more clarity around fees, and those are a good first start towards addressing this problem. But we shouldn't need government regulators to tell us to do the right thing. It's time to shine a light on what participants are paying—and why. Equipping plan sponsors with this information is the first step toward finding lower-cost, flexible and transparent alternatives with iShares ETFs.

What follows is a breakdown of the fees participants pay in 401(k) plans, and a list of fees commonly found in insurance group annuities, mutual funds and iShares ETFs.

1. Source: "ERISA Indemnification and Insurance: Case Studies and Strategies for Plan Fiduciaries," Marcia Wagner. BlackRock, September, 2010.
2. Source: "Small 401(k) Plans Often Pay Big Fees," Kelly Spors, *Wall Street Journal*, August 3, 2009.

Figure 1: Breakdown of 401(k) fees

General plan and advisory expenses

Fees for overall administration of the plan. These commonly occur in plans, although the amounts will vary. We're also providing a starting point for where to find them.

Fee	Description	Where to find it	Who typically pays?
Recordkeeping	Costs of keeping account records	Service contract or initial proposal	Participant or plan sponsor (company)
Administration	Costs of meeting compliance requirements, such as 5500 filings	Service contract or initial proposal	Participant or plan sponsor (company)
Custodian	Costs of storing plan assets	Service contract or custodial agreement	Participant
Setup, conversion	Costs of setting up plan or converting from another provider	Service contract or initial proposal	Participant or plan sponsor (company)
Advisory	Fees charged by financial advisor to plan for investment/asset allocation advice	Advisory or engagement agreement	Participant (most likely) or plan sponsor (company)
Other fees	May include service fees on loans, redemption fees or distribution fees, when a participant withdraws assets from a plan	Varies	Participant

Investment management

Fees for the operational and administrative expenses for the investment options in the plan. Whether these appear in a plan, their amount and where they are listed can vary significantly among plans.

Fee	Description	Where to find it	Who pays?
Management fees	Costs of managing fund, including administration, operations	Fund fact sheet and prospectus	Participant
12(b)-1 fees	Account servicing and distribution, sales costs	Prospectus, enrollment booklet	Participant
Wrap fees	Management fees for group annuity (includes management, administration, operations and marketing)	Annuity contract, disclosure section of participant's website, enrollment booklet	Participant
Trading costs	Costs of fund manager making trades	Supplemental prospectus	Participant
Sub-TA (sub-transfer agent fees)/ revenue sharing	A third party administrator or other entity subcontracted to execute orders or keep records	Prospectus (usually listed as "other")	Participant
Rule 22c-2	Short-term trading redemption fees	Prospectus	Participant

This information is for illustrative purposes only and is not meant to be all-inclusive. Plan sponsors can request all of this information by submitting a letter of authorization to the plan provider.

Figure 2: Investment options and fees

Both hidden and disclosed fees in a 401(k) plan will vary depending on the type of investment options in the plan. Below are three investment options included in 401(k) plans, the fees typically associated with them, and other material differences among them that are important for investors to know.

General plan and advisory expenses that generally occur in all 401(k) plans, irrespective of the investment options

- Recordkeeping/administration
- Custodian
- Setup, conversion
- Advisory
- Other fees

Typical 401(k) investment management expenses

	Group annuities (sub accounts)	Mutual funds	Exchange traded funds
Management fees	✓*	✓	✓
12(b)-1 fees		✓	
Wrap fees	✓		
Trading costs	✓	✓	✓
Sub-TA	✓	✓	
SEC 28(e) soft dollars	✓	✓	
Rule 22c-2	✓	✓	

Descriptions of other differences among popular 401(k) investment options

	Group annuities (sub accounts)	Mutual funds	Exchange traded funds
Strategy	A group annuity is a contract between the investor and the issuer in which the investor invests over time until the payout phase when the issuer agrees to make periodic payments to the investor. It can contain a range of investment options, which are typically mutual funds.	Most mutual funds are actively managed, seeking to outperform market indexes.†	iShares ETFs seek to track a market index, before fees and expenses.
Trading	Purchased through periodic payments, these are then invested in the underlying investment options.	Accessed directly through the fund company or through a select broker. Pricing generally occurs once a day.	Trade on exchanges intraday at market price, which may be greater or less than its NAV. In most 401(k) plans, however, trades are aggregated and occur at the end of the trading day.
Redemption process	Paid out over time after retirement.	Redeemed through fund company at end-of-day NAV, less applicable fees. In 401(k) plans, redemption occurs through Third Party Administrator.	Shares not individually redeemed through the fund. In 401(k) plans, redemption occurs through Third Party Administrator.
Fees	Will include administrative and other fees on top of underlying fund expense ratios	Expense ratios (typically higher for active funds than for index-linked products)‡	Expense ratios plus transaction costs
Transparency of holdings	Generally quarterly holdings disclosure	Generally quarterly holdings disclosure	Daily holdings disclosure§

This information is for illustrative purposes only and is not meant to be all-inclusive.

* Group annuity investors indirectly pay the underlying fund management fees.
† Mutual funds may be either actively managed or track an index. The structure of both active and index mutual funds is similar, however.
‡ Active funds typically charge higher fees than index-linked products due to increased trading and research expenses that may be incurred.
§ In accordance with MSCI licensing, holdings for MSCI-indexed funds are updated monthly.

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Investing involves risk, including possible loss of principal.

Investment comparisons are for illustrative purposes only and are not meant to be all-inclusive. To better understand the similarities and differences between investments, including investment objectives, risks, fees and expenses, it is important to read the products' prospectuses.

The annual management fees of iShares Funds may be substantially less than those of most mutual funds. iShares transactions may result in record-keeping fees, but the savings from lower annual fees can help offset these costs. Other plan fees may apply.

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